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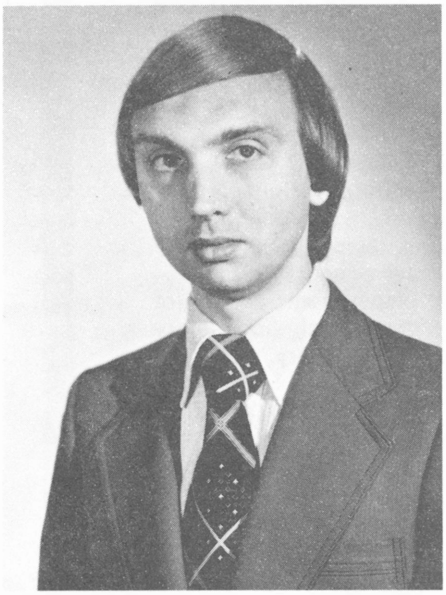

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The role of the public accountant as an auditor has largely been a development of the twentieth century. Although accounting historians make mention of the audit function prior to this time, the early work of the public accountant in the United States was predominantly in the areas of bookkeeping systems, posting, statement preparation and limited examinations for the detection of fraud and errors.

A close relationship can be seen between the development of the audit function and the economic development of the country. Even though by 1900 the United States was one of the world's great manufacturing centers, its economy was still agrarian based with the value of farm products exceeding the value of industrial output. With the twentieth century came the phenomenal growth of American industry, which entailed the development of the corporation as the predominant form of business organization in terms of impact on the economy. As corporations grew larger and more remote from owners, an inherent need for added credibility to financial statements developed. This credibility could be aided by the expression of the opinion of the independent auditor concerning the fairness of presentation of a corporation's financial statements.

The economic growth of this century was not without its problems. Financial abuses, speculation, scandal, panic and monopolistic tendencies marred the early years. With such came the need for legislation and government regulation. Some of the most profound acts of legislation, in terms of their effects on auditing, were the Federal securities acts. Ultimately, the Securities and Exchange Commission was established with its principal objective being the protection of the investor through emphasis upon adequate disclosure. The requirement of financial statements audited by certified public accountants for all companies falling under SEC jurisdiction altered significantly the course of public accounting in America. This says nothing of the effect of the requirement of audited financial statements on the part of numerous other governmental regulatory authorities that have been created during this century.

A Matter of Choice

A publicly held company, meeting the prescribed requirements for registration with the SEC, faces no alternative but to engage the services of an independent certified public accountant in examining its financial statements. The same may be said of companies falling under the regulation of certain other authorities. As a practical matter, irrespective of regulatory bodies, only the smallest of companies generally faces any real decision regarding audited financial statements. Bankers, insurance companies, and significant creditors often make the decision by insisting upon being furnished with audited statements prior to transacting business. In many cases, then, a firm has no available alternative.

It is the small firm, the one that must evaluate and decide upon the desirability of an audit, with which this paper deals. No attempt will be made to define or quantify what is meant by a "small" firm, as such would contribute little and would have no effect upon the statements made herein. As a point of reference, however, a small firm may be thought of as a closely held business, operated by its owner or owners, not subject to control by any of the numerous governmental regulatory authorities and not required by any outsider to provide audited financial statements. The environment is such that each dollar spent is closely enough related to the owner's wealth to require sound justification for all the expenditures. One could ask: Is the cost of an audit not an expense which can be avoided? This question shall be faced by consideration of the advantages and disadvantages of the external audit and its attendant services.

Insight of the Professional

The end-product of an audit is the issuance of the auditor's report on the financial statements of the client. To the proprietor of the small firm, who has very little reservation concerning the financial statements, the auditor's report may be of much less significance than some of the steps followed in arriving at the end-product. For example, early in the examination the auditor must make a study and evaluation of the existing internal control as a basis for his reliance upon the company's accounting records. Among other things, internal control involves the plan of organization and the procedures and records concerned with the safeguarding of assets and the reliability of financial records. Small firms generally are not conducive to the operation of as strong a system of internal control as is possible with a larger firm due, to an inadequate staff for the desired separation of duties and proper system of authorization and documentation. As a result many owners of small businesses attempt to exert their own internal control by "closely over-seeing the entire operation." Of course it is a practical impossibility to examine all transactions unless they are very few in number. In addition, detailed surveillance is less than optimum use of management's time.

It is possible even with a small business to introduce some control procedures and the auditor is in an excellent position to make recommendations. A study of the existing system should point out any weaknesses; suggestions for improved procedures could follow as a normal consequence of auditing expertise.

The intimate relationship that develops between the auditor and client should be emphasized. The examiniation does not entail a mere study of financial statements but delves into the underlying accounting records and operational procedures that gave rise to the accounting records. This investigation coupled with technical competence places the auditor in the position of acting as an adviser to the client, not only with regard to accounting matters but also items indirectly or incidentally related to accounting.

The role of the adviser or consultant can be assumed in several general matters. First of all, informal advice or recommendations may be made from time to time throughout or subsequent to the examination. This is only natural as a result of the close relationship which develops between the auditor and the client.

Secondly, most public accounting firms issue what is commmonly called a management letter at the end of each engagement. Generally this letter to management points out any weaknesses in internal control and accounting or operational procedures. These may have been discussed on an informal basis previously. Serious deficiencies in any of these areas may affect the auditor's ability to render an unqualified opinion.

Many of the items recommended informally or in the management letter may correct relatively apparent weaknesses. However, the owner of the business may have become so involved in the daily operations that the flaws are invisible. An outside party thoroughly familiar with a company often has more insight into needed improvements than one who is preoccupied with the daily routine.

In the course of the auditor's examination, there may become apparent an area, or areas, within the organization that warrant considerable attention. As a result, a formal management consulting contract may be negotiated. Management advisory services have been a rapidly growing facet of the practice of public accounting in recent years. Large public accounting firms have developed management services departments with staffs comprised not only of accountants but also such individuals as industrial engineers, mathematicians, statisticians, data-processing technicians, and wage and salary administrators. Their services include the design and installation of accounting, data-processing, and budget systems; cost and efficiency studies; inventory controls; operational analyses; and financial consultation.

One of the inherent problems of small business is lack of management depth. Only a large firm can justify an internal staff of a size sufficient to include persons with reasonable expertise in the various areas named above. Small firms must either do without such expertise or obtain it externally. The auditor's relationship with his client and his competence in accounting and related areas makes him or his firm the logical source of outside assistance. Familiarity with the client places the auditor a step ahead of any other outsider and, therefore, should make it possible to provide the desired service at minimum cost. Too often a small business owner's function as a "jack of all trades" can lead to serious problems for the company. Outside assistance in areas which demand special abilities may return its initial cost many times.

The Tax Adviser

Any discussion of the services provided by the certified public accountant must certainly turn to tax work. Since first enacted, laws providing for Federal and state income taxes have become increasingly complex to the point that all but the routine individual tax returns require a considerable amount of expertise in preparation. Due to the auditor's familiarity with the client's accounting records and financial affairs, the preparation of the income tax return has become a common extension of the audit engagement. More important than the actual filling in of a form is the contribution which the CPA can make in the area of tax planning. With the Federal income tax rates as significant as they are, the tax impact of many business decisions can be tremendous. Often consideration must be given to the tax effect of a transaction prior to its occurrence to impart the desired effect on the tax return. It is in the planning of transactions that the advice of one highly knowledgeable of the current tax regulations is required. Laws change frequently and are so complicated that only one who works with them regularly can be aware of all that he should in rendering effective tax service.

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Of course the certified public accountant is not the only source of tax service. Income tax returns are prepared commercially by a wide range of individuals and firms in terms of quality. The complexity and significance of taxes are such that the small business owner should demand tax work of a professional caliber, both tax return preparation and tax planning advice. Wise counsel on the part of a skilled professional has quite often resulted in tax savings far in excess of the fee charged for such.

The Owner as an Individual

The establishment of a business relationship with a certified public accountant can be of personal advantage to the owner of a small business. The proprietor frequently tends to be the type of individual whose personal affairs are complex enough to warrant professional assistance in administration. Many types of public accounting services rendered to the company have application to the individual owner. Advice on financial matters, tax return

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preparation, and tax and estate planning are examples of significant services to individuals. Using the CPA in the business gives the proprietor greater access to regular professional counsel than would likely occur with contacts limited to tax preparation. In conjunction with the services rendered the company the public accountant is able to serve the individual proprietor for a reasonable fee.

The Negative Side

As with any consideration of this type, all is not positive. Probably the principal negative point goes back to the proprietor's concern with the cost of the audit. Admittedly this is a cost which could be avoided. The only response to the concern for cost is that the benefits received, such as those discussed herein, must be evaluated in terms of the related cost. If the owner does not feel that the potential benefits justify the cost, then the conclusion is apparent. However, as has been pointed out, the audit and related services can make a significant contribution to the firm so an evaluation should not be made lightly.

A second disadvantage of an audit is that of inconvenience. By necessity there is a certain amount of disruption caused by the presence of an auditor. The numerous inquiries deter the client's employees from the performance of their duties. The smaller the number of employees the greater is the impact on the operation since time spent dealing with the auditor is time not spent in the daily routine. This disruption is inherent in the process and should not be criticized too severely if, in fact, the end-product is considered desirable by management.

In expressing an unqualified opinion of the client's financial statements, the auditor states that they present fairly financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles. Although the exact meaning of the term "generally accepted accounting principles" may be questioned, the Opinions of the Accounting Principles Board and the Statements of the Financial Accounting Standards Board are recognized as authoritative. To many small businesses strict adherence to some of these pronouncements can be a disadvantage.

Consider for example *APB Opinion No. 11,* entitled "Accounting for Income Taxes." Assume that a small business being audited has several items giving rise to timing difference. Proper disclosure under *Opinion No. 11* can easily result in a lengthy and complicated note to the financial statements. The important question is: What does this note tell the owners of this small business? To them the only really important income tax figure is one showing what will have to be paid for the current year. The elaborate presentation of deferred income taxes and items giving rise to them is likely rather meaningless to anyone less than the highly sophisiticated statement reader.

The object here is not to question the propriety of interperiod income tax allocation. Authoritative bodies within the profession have found it to be consistent with sound accrual accounting. Rather, the point is that there are instances where generally accepted accounting principles, though theoretically sound, may not serve a small bsuiness to the same degree that they serve businesses in general.

Another example can be seen in *APB Opinion No. 15,* "Earnings per Share." Situations are rare where the capital structure of a small company is complex enough to require the reporting of primary and fully diluted earnings per share; significance of such elaboration for a closely held business can be questioned.

Types of Opinions

Limitations in the scope of the audit examiniation, either upon request of the client or the existence of limiting conditions within the organization, may make it necessary to issue a qualified opinion. Or, the exceptions that would qualify the opinion may be so material that an adverse opinion is indicated. Significant scope limitations may also preclude the auditor from obtaining sufficient information upon which to base an opinion. As a result there must be a disclaimer of opinion.

Whenever the auditor issues an adverse opinion on the financial statements as a whole or disclaims an opinion, there is the possibility of issuing a piecemeal opinion. In the case of such, the auditor concludes that, in light of the scope of the examination, there is justification for expressing an opinion that is limited to certain items. Due to the interrelationship of many financial statement items, the significance of a piecemeal opinion in most cases is subject to question.

Anything other than an unqualified opinion generally carries a negative or undesirable connotation. This can be a matter of major concern to the company whose statements are to be used externally. Such companies must be certain that their statements conform to generally accepted accounting principles and must do all possible to enable the auditor to obtain sufficient evidence upon which to base an opinion, regardless of the time and cost involved. This entails some disadvantages to a small company, as previously discussed, disadvantages which may override the desirability of an unqualified opinion.

Since the small company is not concerned with the use of its financial statements by outsiders, it may not be disturbed by the absence of an unqualified opinion. The services attendant to an audit can be the predominant contribution of the audit. Where this is the case, the small firm is able to engage the services of the auditor and derive the advantages of such while not conforming to all the requirements for an unqualified opinion.

Conclusion

Many companies have engaged the services of an external auditor on an involuntary basis. Others, in the position of making a choice, often do so with inadequate consideration. The apparent product of an audit — the auditor's report — may be only a small portion of a host of services evolving from the examination. For a small firm, these attendant services can provide access to expertise not possible from within.

The owner of a small business must carefully weigh the benefits which may possibly result from the relationship with the auditor against the costs involved. Clearly this entails consideration of a number of factors, the more obvious of which may be the least significant. Throughout this consideration the proprietor must bear in mind that a positive contribution to a business on the part of a skilled professional can return its cost many times over. The decision, then, must not be made lightly.